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Speech by Governor Kuroda—Flexibility of the YCC

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Introduction

Governor Kuroda made a speech at University of Zurich on Monday this week. For the most part, he reviewed the history of unconventional policy by the BOJ. Nevertheless, when he discussed the remaining challenges for the QQE, he effectively implied some flexibility of managing the YCC.

Posting the speech text on the BOJ's website reinforced the discussion in our domestic market whether the BOJ would conduct a fine-tuning of target rates of the YCC. Let me discuss in detail of the implications of the reference.

Reference to flexibility

In the last section of his speech, Governor Kuroda raised two major issues as remaining challenges for the QQE; one is dispelling the deflationary mindset, and the other is determining the optimal yield curve. Regarding the latter issue, Governor Kuroda reiterated the idea of "natural yield curve" and expressed his intension to continue its discussion with academics and practitioners.

Moreover, Governor Kuroda drew attention to the possibility that policy effect varies depending on the maturity segment of the yield curve. He elaborated that short- to medium-term rates would have the largest impact on economy and prices, while long-term rates could be relevant for financial infrastructure functions such as insurance and pensions.

With this respect, Governor Kuroda referred to the hypothesis of "reversal rate" by Brunnermeier and Koby. According to their analysis, there could be a positive threshold of policy rate, and its reduction beyond this threshold could rather have adverse effects on economy because of impairment of financial intermediation.

While Governor Kuroda confirmed that financial intermediation in Japan remains sound thanks to solid capital base of financial institutions, he cautiously mentioned that the impacts of low interest rate on soundness of financial institutions could be cumulative. All in all, Governor Kuroda committed in pursuing the shape of the yield curve that is deemed most appropriate in order to maintain the momentum toward the inflation target.

A few notable points

First of all, readers may like to remember that Governor Kuroda made similar argument at the regular press conference only a few weeks ago. This fact would make us suspect that the BOJ might have launched a campaign of communication concerning their future course of monetary policy.

Apparently, one of the challenges of possible fine tuning of the YCC would be increasing volatilities in the markets. In light of such risk, the BOJ could have good reason to send some soft message in order to test the market reactions in advance of the actual policy action.

Even if such test could be successfully passed, the BOJ could still face another challenge: risk of losing confidence in monetary policy. It should be noted that the BOJ made commitment in achieving the inflation target in an autonomous manner. If the BOJ would raise the target rates far before its achievement, it could undermine the confidence in the BOJ.

From the political point of view, the BOJ could have a chance to review the target rates of the YCC, when and if Abe administration would declare the victory over deflation. While rates of inflation remain frustratingly low, overall economic performance has been solid. Furthermore, our estimate of GDP gap has been positive, partly thanks to negative real rates for the first time in decades.

Such a chance, however would be uncertain and crucially be dependent on political environment, on which a central bank could not afford to make influence.

Alternatively, the BOJ could argue that the balance of benefits and costs of maintaining the current target rate has changed. In addition to substantial improvement of economic performance, the BOJ could emphasize the risk of growing costs on financial intermediation.

This line of argument is consistent with what Governor Kuroda discussed this time. In light of deteriorating profits of range of financial institutions, fine tuning the YCC–especially "exit" from nominal negative policy rate—would strongly be welcome by the markets. Interestingly, Governor Kuroda made no specific reference to NIRP throughout his speech.

Of course, this is not the end of the story. If and when the BOJ raise O/N policy rate, they need to raise the long-term target rate at the same time. If they fail to do so, financial intermediation would further deteriorate due to further flattening of the yield curve.

This additional task would technically be tough for the BOJ. While the BOJ could raise O/N policy rate by 10bp to exit from NIRP, it is highly uncertain whether the BOJ could raise the target yield of 10Y JGB by as small as 25bp.

With this respect, the BOJ have good reason to modify the target from 10Y to 5Y as suggested by Governor Kuroda's discussion on various policy effects of respective segments of the yield curve, In any case, however, fine adjustment of target yield of the JGB would not be an easy task.

In light of this technical issue, the BOJ might need to wait further for more significant expansion of our economy, which could rationalize a not-so-small adjustment of long-term yield.

A caveat

As far as the rationale for fine tuning of the YCC is the side-effects of financial intermediation, it would be hard for the BOJ to keep raising target rates. Such adjustment would be accomplished in light of new balance of benefits and costs.

Therefore, in my view, at least at this moment, a possible fine tuning of the YCC would be temporary adjustment of policy rate, rather than a concrete start of policy normalization.

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